United States Court of Appeals

for the Second Circuit

BRIEF FOR APPELLEE

Slop.

76-4231

IN THE UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

ALAN NEMSER and SELMA W. NEMSER,

Appellants

v.

COMMISSIONER OF INTERNAL REVENUE,

Appellee

ON APPEAL FROM THE DECISION OF THE

UNITED STATES TAX COURT

BRIEF FOR THE APPELLEE

MYRON C. BAUM,
Acting Assistant Attorney General.

GILBERT E. ANDREWS,
RICHARD W. PERKINS,
ARTHUR L. BAILEY,
Attorneys,
Tax Division,
Department of Justice,
Washington, D.C. 20530.

TABLE OF CONTENTS

CITATIONS

Cases:

IN THE UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 76-4231

ALAN NEMSER and SELMA W. NEMSER,

Appellants

v.

COMMISSIONER OF INTERNAL REVENUE,

Appellee

ON APPEAL FROM THE DECISION OF THE

UNITED STATES TAX COURT

BRIEF FOR THE APPELLEE

STATEMENT OF THE ISSUE PRESENTED

Whether the Tax Court correctly concluded that taxpayer, who purchased a fractional share of a remainder interest in a trust, is not a "beneficiary succeeding to property" so as to be entitled under Section 642(h) 2) of the Internal Revenue Code of 1954 to a deduction on account of excess deductions of that trust in its year of termination.

STATEMENT OF THE CASE

This case involves income tax deficiencies in the amount of $6,782.32 for the 1968 tax year. (R. 10a.)[1/] In an opinion dated July 27, 1976 (R. 9a-20a) the Tax Court (Judge Featherston) ruled in favor of the Commissioner of Internal Revenue and on the same day an appropriate decision was entered (R. 1a.) On October 19, 1976, a notice of appeal was timely filed. (R. 2a.) Jurisdiction is conferred on this Court by Section 7482 of the Internal Revenue Code of 1954.

The facts in this case were stipulated (R. 3a-8a) and may be summarized as follows:

This case concerns taxpayer's purchase of a fractional interest in a testamentary trust created by Silas J. Llewellyn, who died in 1925.

Under the terms of the Llewellyn Trust (Ex. 2-B), Mary Isabelle Llewellyn (Silas' granddaughter) had a remainder interest, the extent of which was contingent upon her father dying without other surviving issue, and her aunt's dying without issue. (R. 11a.) As the opinion of the Appellate Court of the State of Illinois (which had jurisdiction over the construction of the Llewellyn Trust) notes (Ex. 3-C), Mary Isabelle Llewellyn made numerous assignments of fractional interests in her remainder interest under the trust prior to the termination of the Llewellyn Trust. The assignments were for adequate consideration

1/ "R." references are to the separate bound record appendix.

(as the state appellate court's opinion holds) (Ex. 3-C) and were made to various unrelated parties who were willing to purchase an interest in Mary Isabelle's remainder apparently for investment purposes.

One group of investors was a joint venture consisting of Richard Kadish, Irving Poretz, and Aaron Miller who for a total consideration of $31,500 acquired a 75-percent interest in Mary Isabelle's remainder. (R. 4a.) (The state appellate court's opinion indicates that, after the payment of a broker's fee, Mary Isabelle received $15,000 for the March 29, 1946, assignment. (Ex. 3-c, p. 27.)) Ultimately, the amount paid to taxpayer and others by virtue of the March 29, 1946, assignment exceeded $725,000.) (R. 7a.) 2/

On April 17, 1946, shortly after the original assignment, one of the investors in the March 29, 1946, assignment, Richard Kadish, sold and assigned 3/14ths of his 4/9ths interest in the original assignment to taxpayer for the sum of $3,000. (R. 5a, 12a.) Taxpayer's purchase of the 3/14ths interest in Kadish's 4/9ths share in the assignment was for investment purposes (R. 12a).

2/ The original March 29, 1946, assignment, it appears, was a 75-percent interest in the remainder. The state court decree setting forth the shares attributable to various assignments indicates that the original members of the March 29, 1946, joint venture obtained 66-2/3 percent of the final distribution. The discrepancy between these figures is not explained in the record, although the record suggests (Ex. 4-d, p. 24) that the state court decided that one assignee under the March 29, 1946, assignment was not entitled to a share.

All contingencies relative to Mary Isabelle's remainder ended when in 1956, Paul Llewellyn, son of Silas Llewellyn, died, survived only by one child (Mary Isabelle), and when, in the same year, Mary Isabelle's aunt died without issue. (R. 12a.) After a court challenge considering the assignments and other issues (see Ex. 3-C), the assignments were upheld and distributions were made. (R. 13a.) Taxpayer received 10.7142 percent of the 66-2/3 percent share established under the March 29, 1946, assignment. After the deduction of trustee fees and other expenses, taxpayer received stocks having a value of $55,788.16. (R. 14a.)

In the terminal year of the trust (1968), the trust had deductible expenses in excess of the trust income for the termination year. The amount of the excess deductions attributable to the 66-2/3 percent share established under the 1946 assignment was $134,346.15 (R. 14a.) Applying the 10.7142-percent factor to these excess deductions, taxpayer claims that he is entitled to treat $14,394.12 as his "share" of the excess trust deductions, and claimed a deduction for that amount on his 1968 return. (R. 14a.)

Section 642(h)(2) of the Internal Revenue Code of 1954, under which taxpayer seeks the deduction he claims here, permits a trust beneficiary succeeding to the property of a trust to claim a deduction for excess trust deductions which the trust is not able to utilize in a trust termination year. The Commissioner

disallowed the deduction for the reason that taxpayer as a purchaser of part of the beneficiary's interest, was not such a beneficiary. The Tax Court upheld the Commissioner's determination, and, from this adverse ruling, taxpayer appeals.

SUMMARY OF ARGUMENT

The taxpayer in the instant case, who invested $3,000 in 1946 by purchasing a fractional share in a trust remainder, claims a deduction under Section 642(h)(2) of the Internal Revenue Code of 1954. That section permits certain trust beneficiaries to claim a deduction for unused trust deductions in a trust termination year. In the termination year of the trust here involved, it had such unused deductions, and taxpayer seeks a deduction in the amount of approximately $14,000 as his fractional share thereof.

In order to be eligible for the Section 642(h)(2) deduction, which he claims here, taxpayer must be a "beneficiary succeeding to the property" of the trust within the meaning of that section. The Tax Court concluded that he was not such a beneficiary. That conclusion clearly is correct.

First, it is clear that taxpayer does not meet the threshhold requirement of the statute since taxpayer, as a purchaser of a fractional interest in the trust remainder, is simply not a "beneficiary" of the trust. The tax provisions contained in Subchapter J of Chapter 1 of the Code (including Section 642) dealing with the income taxation of trusts and estates contain various rules where a distributee's status as a "beneficiary" is significant, and in numerous situations the courts have given such term a limited meaning. A "beneficiary" generally is a

person who obtains property by gift, bequest, devise, or inheritance. The term as used in Section 642(b), certainly does not include a purchaser of a trust interest. Taxpayer contends that Section 642(h)(2) can apply to any distributee. But the statute on its face only refers to "beneficiaries." Further, Section 643(c) of the Code which states that for purposes of Part I of Subchapter J the term "beneficiary" includes heir, legatee, and devisee, while obviously not intended to be exclusive, indicates (by application of the principle of *ejusdem generis*), that purchasers of trust interests were not among the class of persons intended to reap the benefits of Section 642(h)(2).

Secondly, even if taxpayer could be treated as a beneficiary, within the meaning of Section 642(h)(2), he is not a beneficiary "succeeding to property" within the meaning of that Section. The significant requirement of this phrase, as taxpayer recognizes, is that the beneficiary "bear the burden" of the trust expenses for which no trust deduction could be taken. Taxpayer did not bear such a burden. As the Tax Court noted, the only interest purchased by taxpayer was a fractional portion of the trust principal remaining after losses and administration expenses of the trust had been taken into account. Moreover,

as an investor in a trust remainder, taxpayer must report as taxable income only the amount by which the sum distributed to him exceeds his basis or investment therein. Since it is clear that the trust expenses reduced the amount distributable and thereby taxable to taxpayer, it is readily apparent that taxpayer has no equitable claim to a further tax deduction by virtue of these expenses.

The decision of the Tax Court is correct and should be affirmed.

ARGUMENT

THE TAX COURT CORRECTLY CONCLUDED THAT TAXPAYER IS NOT A "BENEFICIARY SUCCEEDING TO PROPERTY" OF A TRUST FOR PURPOSES OF SECTION 642(h)(2) OF THE INTERNAL REVENUE CODE OF 1954

A. Introduction

The question presented in this case is whether taxpayer, who purchased a fractional share of a trust remainder interest for investment purposes, is entitled to an income tax deduction under Section 642(h)(2) of the Internal Revenue Code of 1954, Appendix, *infra*. That section permits a "[beneficiary] succeeding to the property" of a trust to claim a deduction for certain unused trust deductions where the deductible trust expenses in the termination year exceed trust income for the termination year. In this case, it is undisputed that the Llwewllyn Trust did in fact have excess and unused deductions for the termination year--deductions which would be available for deduction by a beneficiary

described in the statute. The Tax Court ruled that taxpayer is not entitled to the Section 642(h)(2) deduction because taxpayer is not over a beneficiary within the meaning of that section.

Prior to 1954, unused trust deductions could not be carried over to and deducted by the trust beneficiaries upon termination of the trust primarily due to the fact that the deductible expenses had been incurred by the trust, which is itself a taxable entity, not the beneficiaries who are treated as separate taxpayers. To alleviate this problem, Congress added Section 642(h)(2) to the Code in 1954. See 6 Mertens, Law of Federal Income Taxation (Rev.), § 36.106, fn. 2, and this Court's discussion of the enactment of Section 642(h)(2) set forth in Dorfman v. Commissioner, 394 F. 2d 651 (C.A. 2, 1968).

The Section 642(h)(2) requirement that a distributee be a "[beneficiary] succeeding to the property" of a trust actually combines two factors. First, the taxpayer must be a beneficiary as the term is defined for purposes of Section 642(h)(2). Secondly, the taxpayer must be a beneficiary "succeeding to the property of the estate or trust" within the meaning of the phrase for purposes of that section. The significance of the additional phrase is that not all beneficiaries qualify for the unused deduction carryover provision, but only those beneficiaries who "bear the burden" of the unused loss or excess deductions to which Section 642(h)(2) relates. See § 1.642(h)-3(a) of the Treasury Regulations on Income Tax (1954 Code), Appendix, infra. Thus, a

beneficiary who is entitled to a specific sum from a trust is generally not entitled to claim the benefits of the Section 642(h)(2) deduction, except to the extent that trust corpus is insufficient to pay the sum to which he is entitled. The same principle applies in the case of estates. According, in trust cases, it is normally the remaindermen who benefit from the Section 642(h)(2) deduction and, in the case of estates, it is normally the residuary beneficiaries, and not specific legatees or devisees, who benefit from that section. See § 1.642(h)-3(c) and (d) of the Treasury Regulations on Income Tax, Appendix, infra, and 6 Mertens, Law of Federal Income Taxation (Rev.), § 36.106.

The Tax Court, in effect, ruled that neither requirement was met here. As a purchaser or investor who bought the right to receive a portion of the trust corpus payable to the remaindermen upon termination of the trust, the taxpayer simply was not a "beneficiary" for purposes of Section 642(h)(2). Further, the Tax Court ruled that taxpayer did not "bear the burden" of the trust expenses in question and so was not a "[beneficiary] succeeding to the property" of the trust within the meaning of that section.

B. <u>Taxpayer is not a "beneficiary" within the meaning of Section 642(h)(2) of the Code</u>

Taxpayer here argues for a sweeping if not virtually limitless definition of the term "beneficiary" as used in Section 642(h)(2). He contends (Br. 6-10) that any ultimate distributee of trust property can qualify as a beneficiary for purposes of that section. However, taxpayer fails to offer any authority in support of this argument (see fn. 3, <u>infra</u>), and it is manifestly incorrect.

Contrary to taxpayer's position, it is clear that, as the Tax Court concluded, the term "beneficiary" was intended to refer only to these persons (in the case of estates), who acquire their interest by "bequest, devise, or inheritance under State succession laws." (R. 17a.) The Tax Court's view that this term does not extend to persons who purchase rights from such beneficiaries, so as to qualify such purchasers as "beneficiaries" under Section 642(h)(2), is inferentially supported by the statutory definition of the term "beneficiary" which taxpayer fails even to cite on brief. Section 643(c) of the Internal Revenue Code of 1954, Appendix, <u>infra</u>, provides that the term "beneficiary" includes an "heir, legatee, [or] devisee." Thus, by application of the principle of <u>ejusdem</u> <u>generis</u>, this statutory

definition of the term beneficiary indicates that persons acquiring interests in trust by purchase were not generally intended to be viewed as beneficiaries for purposes of Subchapter J of the Code.[3/]

In addition to the statutory definition of the term "beneficiary," the normal meaning of the term which controls in these matters[4/] supports the Commissioner's position here that taxpayer is not a "beneficiary." As the court explained in Renton Inv. Co. v. Commissioner, 131 F. 2d 330, 335 (C.A. 9, 1942):

> [A beneficiary is] one who receives anything as a gift; one who receives a benefit or advantage; the recipient of another's bounty * * *.

Surely taxpayer is not a "beneficiary" of the Llewellyn Trust within this meaning of the term. Taxpayer did not receive something by "gift" or as "another's bounty." Taxpayer was an investor

3/ Taxpayer contends (Br. 5) that a strict reading of the statute would only permit treating persons acquiring property under state intestate succession laws as "beneficiaries" and questions on what authority the Tax Court relied in referring to bequests or devises. Taxpayer suggests that if the statute can be extended to include bequests or devises without express authorization, that it is improper not to extend the statute further to include persons acquiring trust property by purchase. The principal flaw in taxpayer's "extension" argument is the existence of the statutory provision (Section 643(c)) which defines the term "beneficiary" to include persons acquiring property by "bequest, devise, and inheritance." The statute expressly supports the Tax Court's interpretation but says absolutely nothing to buttress taxpayer's position.

4/ See Berkeley Hall School, Inc. v. Commissioner, 31 B.T.A. 1116, aff'd, 84 F. 2d 539 (C.A. 9, 1936).

who in 1946 for $3,000 speculated that certain contingencies would occur and cause a distribution of trust funds to him. The gamble paid off handsomely. For $3,000, invested in 1946, taxpayer ultimately became entitled in 1956 to a sum which, when distributed in 1968, exceeded $55,000.[5/] However profitable this may have been for taxpayer, it is clear that there was no "gift" or "bounty" involved.[6/]

In the only other reported case involving interpretation of the provisions of Section 642(h)(2), the Code section at issue here, the Tax Court in Sletteland v. Commissioner, 43 T.C. 602 (1965), ruled that a lawyer to whom trust property had been assigned as compensation for services did not qualify as a "beneficiary" for purposes of Section 642(h)(2) of the Code. The taxpayer there, just as the taxpayer here, sought the benefit of the excess deduction pass-through rules, but the Tax Court concluded that the provisions of Section 642(h)(2) were not intended to benefit a mere assignee of trust property.

5/ By contrast, Mary Isabelle Llewellyn, who sold the rights involved obtained, after expenses, $15,000 for rights to a remainder payment which in 1968 exceeded $725,000.

6/ It should be noted that the state court concluded that the original purchasers paid "adequate" consideration for the rights to receive a portion of the distribution to the remainderman. (Ex. 3-C, pp. 30-31.)

In Sloane v. Commissioner, 188 F. 2d 254 (C.A. 6, 1951), the court ruled that an assignee of trust property who was directed to sell the property at a minimum price for the benefit of the trust but who was entitled to retain any excess purchase price in consideration of services rendered by him was held not to qualify as a "beneficiary" for purposes of the income characterization pass-through provisions of Subchapter J (see Sections 652(b) and 662(b) of the Code (26 U.S.C.).) The income was capital gains to the trust and would have retained this preferential character if distributed to a "beneficiary," but the assignee-taxpayer involved in Sloane was not a "beneficiary" for this purpose.

The courts have also recognized in several cases that assignees or purchasers are not "beneficiaries" for trust deduction purposes. In Helvering v. Butterworth, 290 U.S. 365 (1933), the court was faced with a trust deduction claim (not involving Section 642(h)(2)) in a case where a decedent's widow elected to take under her husband's will and to receive the income of a trust established thereunder in lieu of taking her statutory share of the testator's estate. The court there ruled that the wife qualified as a "beneficiary" (which permitted the trust to deduct income distributions to her) but this ruling was made necessary by the fact that if she were held to be a "purchaser", no deduction would have been allowed.

See also Thomas Lonergan Trust v. Commissioner, 6 T.C. 715 (1946), another trust deduction case, where the Tax Court ruled that a creditor of the decedent to whom a trustee made a distribution was not a "beneficiary."

In another line of cases involving persons who purchase rights from trust beneficiaries the courts have consistently recognized that the purchaser of a beneficiary's rights is not taxed as a "beneficiary" within the meaning of the general provisions dealing with estates and trusts. Rather, the purchaser treated as a normal investor, who, depending on the amount of his investment and the amount of the ultimate distribution, recognizes income or loss on his venture.

In this regard the law is well settled that the purchase and sale of a trust interest is treated as a purchase and sale of a capital asset. The seller (the actual beneficiary) reports the proceeds as gain from the sale of a capital asset. Bell's Estate v. Commissioner, 137 F. 2d 454 (C.A. 8, 1943). If the seller experiences a loss, he may claim a loss deduction in the year of sale. McAllister v. Commissioner, 157 F. 2d 235 (C.A. 2, 1946). The purchaser of a trust interest must report as income the amounts distributed to him only to the extent the amounts distributed exceed his basis (i.e., the amount paid for the interest) in the property. See Bell v. Harrison, 212 F. 2d 253 (C.A. 7, 1954).

It is readily apparent from these cases that a purchaser of a trust interest does not become the "beneficiary" of the trust for tax purposes.[7/] Specifically, such a purchaser is not taxed as a "beneficiary," i.e., on all income distributed to him, but instead treats trust distributions as gains from dealings in property, as Bell v. Harrison, supra, demonstrates.

7/ There is language in Blair v. Commissioner, 300 U.S. 5 (1937), which held that assignees of income interests in a trust which had been transferred by gift were taxable on the income distributed to them, which states that such assignees "become the beneficiar[ies]" of the trust. The issue presented there, however, was whether the donor of those interests was liable for the income taxes on the income distributions, notwithstanding the assignments. In holding that he was not, the court's decision turned on principles of tax law generally applicable in the "assignment of income" area, rather than on principles peculiar to the taxation of trusts and their beneficiaries, as the court recognized when it stated that the decision there was governed by the principle in the "general application of the revenue acts" that "the tax liability attaches to ownership" (p. 12). There was no occasion in Blair to become involved in analysis of cases such as Butterworth, supra, where more precise delineation of who is a "beneficiary" of a trust is necessary to determine the correct application of principles peculiar to Subchapter J. See also Harrison v. Schaffner, 312 U.S. 579, 582 (1941) and this Court's decision in McAllister v. Commissioner, supra, p. 236, recognizing this rationale for Blair (i.e., that income is taxed to the owner). The present case, however, does not involve any question concerning the proper taxpayer for purposes of distributions of trust income and so the Blair case is limited significance here. The point of importance here is that a purchaser of trust income is not taxed as a beneficiary under the trust provisions (i.e., on all income distributed) but instead is taxed on his gain from the transaction (i.e., the amount distributed in excess of basis.) See Bell v. Harrison, supra.

The sole authority relied on by taxpayer here is found in the legislative history relating to the enactment of Section 642(h)(2) of the Code. Taxpayer (Br. 7) cites the Senate Report which states that the Section 642(h)(2) deduction is "available to the remainderman to whom the property is distributed" and (Br. 8) to the House Report which states that the deduction is available "to the beneficiaries or remainderman succeeding to the property." Based on this language taxpayer concludes (Br. 8) that any person "to whom the property is distributed" or who "succeeds to property" can qualify for the Section 642(h)(2) deduction. Taxpayer, however, overlooks the language contained in the Committee Reports referring to "remaindermen" and "beneficiaries" as the parties to whom the deduction is available and also fails to acknowledge the fact that the statute refers to "beneficiaries" (not distributees). Taxpayer also fails to refer to the fact that the statute (Sec. 643(c)) contains a definition of that term which supports the Tax Court's reasoning. (See fn. 4, supra.) Moreover, as we have shown, the cases construing the term "beneficiary" run counter to the notion that purchasers of a beneficiary's trust interest are "beneficiaries" for purposes of Section 642(h)(2).

In sum, taxpayer is not a "beneficiary" within the meaning of that term as used in Section 642(h)(2) of the Code. Taxpayer is, instead, a purchaser or investor and his status as such precludes treatment for him as such a "beneficiary."

C. <u>In any event, taxpayer is not a "[beneficiary] succeeding to the property" within the meaning of Section 642(h)(2) of the Code</u>

As we have indicated, taxpayer is not a trust "beneficiary" within the meaning of Section 642(h)(2) and, therefore, does not satisfy the threshold requirement of that section. But even if taxpayer were such a "beneficiary," it would be necessary for him to show that he is a "[beneficiary] succeeding to the property" within the meaning of Section 642(h)(2). The Tax Court correctly ruled (R. 19a) that taxpayer failed to satisfy this additional requirement of the statute.

Taxpayer does not challenge (Br. 6-7) the Regulations which define the phase "beneficiaries succeeding to the property of an estate or trust." The Regulations, Section 1.642(h)-3(a), provide:

> The phase 'beneficiaries succeeding to the property of an estate or trust' means those beneficiaries upon termination of the estate or trust who <u>bear the burden</u> of any loss for which a carryover is allowed, or of any excess of deductions over gross income for which a deduction is allowed, under section 642(h). (Emphasis added.)

It is clear that, as the Tax Court concluded (R. 19a), taxpayer did not "bear the burden" of the trust expenses at issue here. The nub of taxpayer's "bear the burden" argument (Br. 11-13) is that the trust expenses at issue here reduced by $14,394.12 the amount of trust corpus available for distribution to him. But this contention begs the question here presented. As the Tax Court noted (R. 19a), the only interest purchased by taxpayer was a fractional portion of the trust principal remaining

after the expenses of its administration and liquidation had been paid. Moreover, as the decision in Bell v. Harrison, supra, makes clear, the purchaser of trust rights reports as income only the amount by which the amounts distributed exceed his basis in the interest. Thus, taxpayer here must report as a taxable income only the amount by which the $55,788.16 distribution to him (R. 14a) exceeds his cost basis ($3,000) in the property. By using the amount distributed as the starting point in this analysis and not the amount available for distribution prior to allowance of the trust expenses, it is readily apparent that taxpayer has not suffered any adverse tax consequences by reason of the $14,394.12 in trust expenses.8/ Specifically, the amount available for distribution to taxpayer (prior to an allowance for the trust expenses) would have been $70,182.28 ($55,788.16 + $14,394.12.) But only the amount actually distributed to taxpayer is taxable as his income from this transaction, and this amount ($55,788.16) already reflects the fact that the $14,394.12 in trust expenses has been used to reduce the amount taxable. Since taxpayer had nothing more than the right to receive the amount available for

8/ It should be noted that acceptance of taxpayer's position would permit anyone to purchase a tax benefit from a trust beneficiary. For example, if a trust with corpus of $1,000 and unused trust deductions of $5,000 were about to terminate and distribute the $1,000 to the remainderman, the remainderman, under taxpayer's theory, could bargain to sell his $1,000 remainder to a purchaser who, in a higher tax bracket, would be willing to pay much more than $1,000 in order to obtain the use of the $5,000 deduction. The statute on its face does not authorize such trafficking in tax deductions and Congress has not indicated any desire or intent to permit tax bonanzas to such purchasers.

distribution after the payment of trust expenses and since taxpayer should report as income only the amount actually distributed (minus his basis), there simply is no justification for giving taxpayer the windfall of a further deduction for the \$14,394.12 in trust expenses.

Moreover, the situation of taxpayer as an investor who reports the amounts of trust corpus distributed to him as taxable income, underscores the fact that he has not borne a burden within the meaning of Section 1.642(h)-3(a) of the Treasury Regulations on Income Tax. Normally a remainderman or residuary beneficiary of a trust would not include in income the amounts of trust corpus distributed to such person upon termination of the trust. Such amounts are excluded from income as amounts obtained by "gift, bequest, [or] devise" in accordance with Section 102 of the Code (26 U.S.C.). Since Regulations Section 1.642(h)-3(a) refers to a beneficiary who "bear[s] the burden" of the expenses, in the context of the tax laws relative to gifts, etc., which are excluded from income, it is clear that this phrase refers to the reduction in a beneficiary's gift, bequest or devise which results from the trust expenses being paid out of trust corpus. Obviously, an investor who treats such trust distributions as taxable income has not experienced a reduction in a tax-free gift, bequest, or devise, to which Section 642(h)(2) normally applies.[9/]

9/ And, as we have shown, the taxable event experienced by the "investor" in trust interests already takes in account the fact that the trust expenses reduced the amount taxable to him.

In sum, taxpayer has not borne the burden of the trust expenses in issue within the meaning of Section 1.642(h)-3(a) of the Regulations and, therefore, is not a "[beneficiary] succeeding to property" within the meaning of Section 642(h)(2) of the Code.

CONCLUSION

The decision of the Tax Court is correct and should be affirmed.

Respectfully submitted,

MYRON C. BAUM,
Acting Assistant Attorney General.

GILBERT E. ANDREWS,
RICHARD W. PERKINS,
ARTHUR L. BAILEY,
Attorneys,
Tax Division,
Department of Justice,
Washington, D.C. 20530.

JANUARY, 1977.

CERTIFICATE OF SERVICE

It is hereby certified that service of this brief has been made on taxpayer, appearing pro se, by mailing four copies on this 19th day of January, 1977, in an envelope, with postage prepaid, properly addressed to him as follows:

Alan Nemser, Esquire
32 Court Street
Brooklyn, New York 11201

Gilbert E. Andrews/enb
GILBERT E. ANDREWS,
Attorney.

APPENDIX

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 642. SPECIAL RULES FOR CREDITS AND DEDUCTIONS.

* * *

(h) Unusued Loss Carryovers and Excess Deductions on Termination Available to Beneficiaries.--If on the termination of an estate or trust, the estate or trust has--

* * *

(2) for the last taxable year of the estate or trust deductions (other than the deductions allowed under subsections (b) or (c) in excess of gross income for such year,

then such carryover or such excess shall be allowed as a deduction, in accordance with regulations prescribed by the Secretary or his delegate, to the beneficiaries succeeding to the property of the estate or trust.

* * *

SEC. 643. DEFINITIONS APPLICABLE TO SUBPARTS A, B, C, AND D.

* * *

(c) Beneficiary.--For purposes of this part, the term "beneficiary" includes heir, legatee, devisee.

Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.):

§ 1.642(h)-3 Meaning of "beneficiaries succeeding to the property of the estate or trust".

(a) The phrase "beneficiaries succeeding to the property of the estate or trust" means those beneficiaries upon termination of the estate or trust who bear the burden of any loss for which a carryover is allowed, or of any excess of deductions over gross income for which a deduction is allowed, under section 642(h).

* * *

(c) In the case of a testate estate, the phrase normally means the residuary beneficiaries (including a residuary trust), and not specific legatees or devisees, pecuniary legatees, or other nonresiduary beneficiaries. However, the phrase does not include the recipient of a specific sum of money even though it is payable out of the residue except to the extent that it is not payable in full. On the other hand the phrase includes a beneficiary (including a trust) who is not strictly a residuary beneficiary but whose devise or bequest is determined by the value of the decedent's estate as reduced by the loss or deductions in question. Thus the phrase includes:

(1) A beneficiary of a fraction of a decedent's net estate after payment of debts, expenses, etc.;

(2) A nonresiduary legatee or devisee, to the extent of any deficiency in his legacy or devise resulting from the insufficiency of the estate to satisfy it in full;

(3) A surviving spouse receiving a fractional share of an estate in fee under a statutory right of election, to the extent that the loss or deductions are taken into account in determining the share. However, the phrase does not include a recipient of dower or curtesy, or any income beneficiary of the estate or trust from which the loss or excess deduction is carried over.

(d) The principles discussed in paragraph (c) of this section are equally applicable to trust beneficiaries. A remainderman who receives all or a fractional share of the property of a trust as a result of the final termination of the trust is a beneficiary succeeding to the property of the trust. For example, if property is transferred to pay the income to A for life and then to pay $10,000 to B and distribute the balance of the trust corpus to C, C and not B is considered to be the succeeding beneficiary except to the extent that the trust corpus is insufficient to pay B $10,000.